Uncertainty in the Outlook

While every economic forecast is subject to great uncertainty, a number of special factors combine to render forecasts made at this time particularly uncertain. Some fundamental uncertainties in the present forecast include:

- The impact on the economy of the shift in fiscal policy toward greater restraint, as mandated by the Balanced Budget Act;
- The economic impact of the Tax Reform Act of 1986, which changes the composition of federal receipts and substantially alters incentives for many economic activities;
- The ability of OPEC oil producers to maintain oil prices at their current levels; and
- The speed and strength of the response of exports and imports to the dollar depreciation.

THE BUDGET OUTLOOK

CBO's baseline budget projections reflect the new economic forecast and medium-term projections, the latest information on tax collections and spending patterns, and estimates of the effect of recently enacted legislation. As they did last year, the projections assume that both defense and nondefense discretionary appropriations are held constant in real terms and that current tax and entitlement laws are not changed. Under these assumptions, the deficit is projected to decline from $221 billion in 1986 to $85 billion in 1992 (see Summary Table 1). These budget projections will be updated as necessary in February to take account of information gained from the Administration's Fiscal Year 1988 Budget submission.

The 1988 baseline deficit exceeds the Balanced Budget Act's target by $61 billion. The deficit targets decline at a faster rate than the baseline in future years so that the gap between the baseline and the annual deficit targets grows to $109 billion by 1991. Under the Balanced Budget Act, the Congress could choose to meet the 1988 deficit target by across-the-board spending cuts referred to as sequestration. Under CBO's baseline assumptions, these cuts would have to be 14 percent for defense programs and 20 percent for nondefense programs from 1987 appropriations levels.

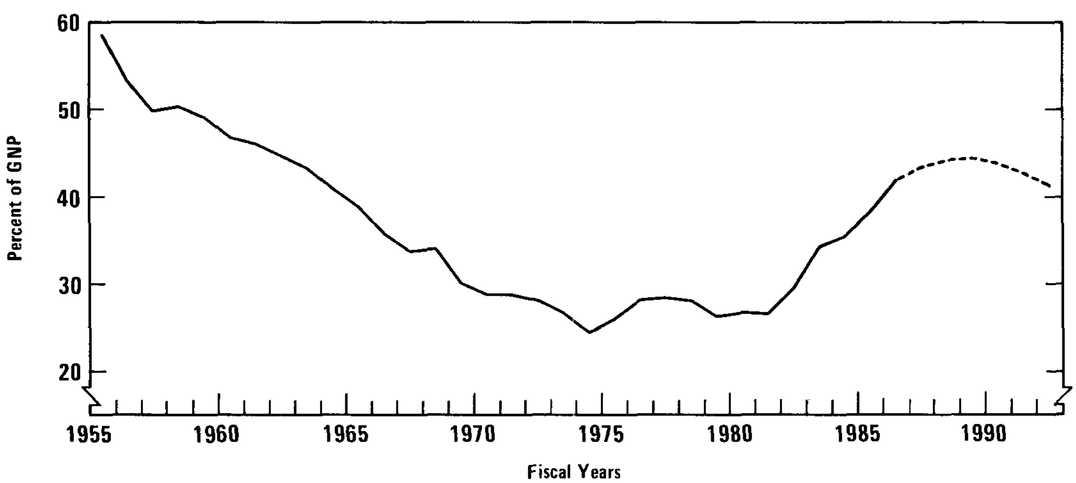
As the result of continuing budget deficits, debt held by the public is projected to grow from $1.7 trillion at the end of 1986 to over $2.5 trillion by the end of fiscal year 1992. The federal government's debt has grown faster than the economy since the early 1980s, but CBO's baseline projections of declining deficits show an end to this trend. The ratio of debt to GNP under CBO's baseline assumptions peaks at 44 percent in the 1988-1990 period and then falls to 41 percent in 1992--very close to its current level (see Summary Figure 3). The decline in the debt-to-GNP ratio will obviously be sharper if the deficit targets of the Balanced Budget Act are met.

Changes in Baseline Projections

Projected baseline deficits for 1988-1991 are higher than projected by CBO last August despite the enactment of legislation in October to reduce spending and increase revenues. Under CBO's August 1986 economic and technical assumptions, the Omnibus Budget Reconciliation Act, the Tax Reform Act, and the continuing resolution for appropriations would have reduced the 1987 deficit to about $151 billion--within $10 billion of the Balanced Budget Act's target. But CBO's new economic and technical assumptions raise the 1987 deficit estimate to $174 billion. Moreover, most of the budget savings from enacted legislation last year were one-time savings. While the savings attributable to legislation were $32 billion in

Summary Figure 3.

Federal Debt Held by the Public



SOURCES: Congressional Budget Office; Office of Management and Budget; Department of the Treasury; Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1987-1992 fiscal years are consistent with the CBO baseline.

1987, the annual savings average only $6 billion in 1988-1991 (see Summary Table 3).

Revised economic assumptions add to the deficit by amounts growing from $10 billion in 1987 to $25 billion by 1991. Lower levels of nominal GNP and changes in the composition of national income cause estimated revenues to be lower by amounts growing from $13 billion in 1987 to $22 billion in 1991. Lower projected interest rates, however, reduce debt-service costs and attenuate somewhat the budgetary effect of lower revenues.

Technical reestimates, primarily on the spending side, increase the projected deficits substantially in all years. Medicaid and Medicare spending in 1986 exceeded expectations; this growth is expected to continue, adding $3 billion to spending in 1987 and $7 billion by 1991. Changes in the outlook for U.S. agricultural exports and other factors increase outlays for farm price supports by $3 billion in 1987 and about $6 billion per year in the 1988-1991 period. Revised defense spending estimates add less than $1 billion to 1987 outlays but about $3 billion per year thereafter. Projected outlays have also risen by an average of $1½ billion per year for unemployment compensation and $1 billion per year for assistance payments

SUMMARY TABLE 3. CHANGES FROM CBO AUGUST BASELINE DEFICIT PROJECTIONS (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
CBO August 1986 Baseline Deficit	184	150	127	96	69
Enacted legislation	-32	-9	a/	-5	-10
Revised economic assumptions	10	11	15	19	25
Technical reestimates	13	17	20	24	25
CBO January 1987 Baseline Deficit	174	169	162	134	109

SOURCE: Congressional Budget Office.

a. Less than $500 million.

and Supplemental Security Income. Those increases reflect recent spending experience. Finally, based on spending plans of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, estimated federal assistance to troubled financial institutions will grow by more than $4 billion in 1987.

Uncertainty of Budget Estimates

The changes in the baseline deficit projections because of revised economic assumptions and technical reestimates demonstrate the uncertainty of budget estimates. Relatively small changes in the economic outlook can have major implications for the budget deficit. For example, an increase of one percentage point in all government interest rates would increase the deficit by $11 billion in 1988 and $26 billion in 1992.

Significant changes in the estimates can also occur for reasons unrelated to the health of the overall economy. For example, unexpected increases in the cost of farm price supports, federal health programs, financial deposit insurance programs, and unemployment compensation have added $12 billion to CBO's estimate of the 1987 deficit since last August. In recent years, errors in technical estimating assumptions have caused the targets in first Congressional budget resolutions to differ from actual deficits by an average of $17 billion. Although technical estimating errors of this size are relatively small percentages of spending and revenues, the same errors are larger as a percent of the deficit.

CHAPTER I

THE ECONOMIC OUTLOOK

In 1986, the economy continued to grow at the moderate pace set in 1985. Despite reductions in interest rates, oil prices, and the international value of the dollar early in the year, the economy's growth over the four quarters of 1986 was slightly below that of 1985. Domestic demand for goods and services registered relatively strong growth, but an increasing share of the rising demand was met by foreign producers. This foreign competition restrained the growth of domestic economic activity, particularly for manufacturers. By the end of 1986, however, industrial production and employment appeared to be improving, and most forecasters were anticipating a turnaround in foreign trade.

The Congressional Budget Office (CBO) forecasts slightly higher real growth in the next two years. This forecast depends crucially on a substantial reduction in the trade deficit. CBO also projects somewhat higher inflation, accompanied by steady interest rates and a gradual decline in the rate of unemployment from its 1986 level.

THE CBO ECONOMIC FORECAST AND MEDIUM-TERM PROJECTIONS

The Congressional Budget Office's economic projection has two parts: a short-term forecast of economic conditions through 1988 contingent on specific policy assumptions; and a medium-term projection through 1992 based on historical trends and other assumptions about economic growth.

The Short-Term Forecast

The CBO short-term forecast calls for continued expansion over the next two years at a rate somewhat higher than the past two years. This forecast is based on specific assumptions for fiscal and monetary policy:

- Federal tax and spending policies for fiscal year 1988 are assumed to satisfy the deficit requirements of the Balanced Budget Act.

Since the policies for that year are not known, CBO assumes equal across-the-board revenue increases and spending cuts, after incorporating an estimate of asset sales.

- The Federal Reserve is assumed to follow a policy that would allow M2 to remain within its target range.

The CBO forecast also assumes that:

- The world price of oil will be close to $15 per barrel through the end of 1988. This assumption was based on futures market prices at the time the forecast was prepared in December 1986. Since that time, oil prices have risen to the range of $18.00 to $19.00 per barrel. If these higher oil prices prevail, the CBO projection will have understated the contributions of energy prices to inflation in 1987.

- The exchange rate (the Federal Reserve Board index) continues to decline, though at a much slower rate than over the past year, reaching by the end of 1988 a level about 10 percent below its average at the end of 1986.

- Food prices rise by about 4 percent throughout the forecast period.

Given these assumptions, CBO expects that real gross national product (GNP) will grow at about a 3 percent annual rate between the fourth quarters of 1986 and 1988 (see Table I-1). Although the growth rate will not be constant over this period, there is no basis on which to predict any particular pattern of growth over the forecast period. Inflation at the consumer level is expected to rise to around 4½ percent, since the special factors (falling prices for oil, agricultural goods, and other commodities) that depressed inflation in 1986 below its underlying rate will not recur, and higher prices for oil and other imports will begin to affect domestic prices. The increase in inflation as measured by the GNP deflator is expected to be significantly less than that measured by the Consumer Price Index (CPI) because import prices are excluded from the GNP deflator but not from the CPI, and because oil has a lower weight in the GNP deflator. 1/ The

1. The CPI is published in two versions: the CPI-W for urban wage earners and clerical workers, shown in the projections in Tables I-2, I-3, and I-4; and the CPI-U for all urban consumers, which appears in the discussion of inflation later in this chapter.

unemployment rate is expected to average 6.6 percent in 1987, a small decline from its average in 1986; in 1988, it is expected to drop further to around 6.5 percent. Although the interest rate on three-month Treasury bills is projected to rise slightly in 1987 from current levels, the increase is expected to be less than the rise in inflation. Yields on 10-year Treasury bonds are forecast to remain at or near current levels. As a result, real interest rates decline in the forecast period.

The outlook for domestic spending offers little to support a projection of strong economic growth. Consumer spending will probably not be a major source of strength. There has been a huge rise in wealth, but this has already been reflected in consumption. Therefore, consumer spending is unlikely to grow more quickly than disposable income. According to recent surveys, business investment spending, which in mid-1986 was expected to improve in 1987, may turn out to be weak. Real government purchases of goods and services will be reduced under the constraints of the Balanced Budget Act.

Net exports, on the other hand, are likely to support economic growth. CBO expects the balance in real net exports to increase substantially

TABLE I-1. THE CBO FORECAST FOR 1987 AND 1988

	Actual	Estimated	Forecast	
	1985	1986	1987	1988
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	6.3	5.1	6.5	7.1
Real GNP	2.9	2.5	3.0	2.9
Implicit GNP Deflator	3.3	2.6	3.4	4.0
CPI-W	3.2	1.1	4.4	4.4
Calendar-Year Averages (percent)				
Unemployment Rate	7.2	7.0	6.6	6.5
Three-Month Treasury Bill Rate	7.5	6.0	5.6	5.7
Ten-Year Government Bond Rate	10.6	7.7	7.2	7.2

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

between the end of 1986 and the end of 1988. This improvement is the result of the decline in the dollar, much of which has already taken place, as well as the recent low rate of wage inflation in the United States.

The growth forecast by CBO for the next two years falls within the range of 2.0 percent to 3.5 percent anticipated by most forecasters. Forecasts made at this time, however, are subject to an unusual number of uncertainties, including:

- The effects on the economy of the restrictive shift in fiscal policy mandated by the Balanced Budget Act;
- The economic impact of the Tax Reform Act passed at the end of 1986, which changes the composition and sources of federal receipts and alters incentives for economic activities such as saving, working, and various forms of investment;
- The actions of OPEC oil producers;
- The future course of the dollar and the speed with which the recent decline in the value of the dollar will work to improve the real trade balance;
- The effects of relatively high household and business debt, which could cause a sudden retrenchment of spending.

Medium-Term Economic Projections

CBO's medium-term projections for 1989 through 1992, presented in Tables I-2 and I-3, indicate that real GNP growth will average 2.7 percent and the unemployment rate will decline slowly to about 6.0 percent. The medium-term projection of GNP is based largely on projections of gross domestic product (GDP), which differs from GNP in that it does not include the net income U.S. residents earn on assets held overseas.

The projections are constructed from rules of thumb that have a historical basis. They are not designed to be consistent with any particular set of policy assumptions. Real GDP is assumed to grow at its average postwar rate (about 3.2 percent) until it reaches CBO's estimate of potential GDP in 1990. 2/ Thereafter, actual GDP is assumed to grow at the estimated rate of growth of potential GDP (2.6 percent). This path for real GDP, when combined with an estimated relationship between real GDP growth and

2. Potential GDP is the highest level of output that can be sustained without increasing inflation. Methods of estimating potential GDP are discussed in Chapter III.

unemployment, will bring the unemployment rate down to 6 percent by mid-1990 and keep it constant thereafter.

While the trade deficits on current account should improve, net U.S. indebtedness to foreigners will continue to rise for many years and thus reduce the flow of net income from abroad. Gross national product is therefore expected to grow a bit more slowly than GDP. The inflation rate, as measured by the GNP deflator, is assumed to remain constant at 4.2 percent, which is its long-term average in the years 1948 through 1986. By the end of 1992, interest rates are assumed to decline to levels that will approximate the historical average for the real short-term rate, and CBO estimates a spread between the nominal short- and long-term rates of about 50 basis points.

The Tax Base. Projections of federal revenues depend in part on how wages, profits, and other incomes are assumed to behave (see Table I-3). Taxable wages are assumed to grow slightly faster relative to GNP in the next few years than in the recent past for two reasons:

- o Many analysts believe that the rise in the dollar between 1980 and 1985 helped to hold down wages, especially in the tradeable-goods industries. The recent decline in the dollar and the consequent projected improvement in net exports is expected to permit somewhat stronger growth in wages.

- o The growth of nontaxable fringe benefits (pensions, health insurance contributions, and so forth) relative to wages appears to have stopped, and taxable wages therefore should grow as fast as total compensation. 3/

Lower interest rates and a slowing of the growth of the federal debt will mean that personal interest payments will account for a declining share of GNP. These payments are a major component of other taxable income (see Tables I-2 and I-3). Profits will be held back by higher real wage

3. One of the major sources of relative growth in fringe benefits--health care insurance--appears to have been checked in recent years. The growth in pension plan assets resulting from the stock market's rise has recently permitted employers to reduce contributions or to reorganize plans, in effect extracting their previous contributions. This practice may not continue, however, particularly if the stock market were to fall significantly. Nontaxable fringe benefits may also begin to grow again as a result of the increasing prevalence of 401K plans, which give some employees the option of converting taxable wages into tax-deferred pension contributions. Although the Tax Reform Act restricts the use of 401K plans, the federal government has recently started such a plan for its own employees. The expected growth in private 401K plans, which is not incorporated in the economic projections, has been taken into account in computing revenue projections.

TABLE I-2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1989-1992

Economic Variable	Estimated 1986	Forecast 1987	Forecast 1988	Projected 1989	Projected 1990	Projected 1991	Projected 1992
Nominal GNP (billions of dollars)	4,216	4,469	4,779	5,124	5,503	5,888	6,288
Nominal GNP (percent change)	5.4	6.0	6.9	7.2	7.4	7.0	6.8
Real GNP (percent change)	2.6	2.8	3.0	3.0	3.1	2.7	2.5
Implicit GNP Deflator (percent change)	2.8	3.2	3.8	4.1	4.2	4.2	4.2
CPI-W (percent change)	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Unemployment Rate (percent)	7.0	6.6	6.5	6.3	6.1	6.0	6.0
Three-Month Treasury Bill Rate (percent)	6.0	5.6	5.7	5.6	5.5	5.3	5.2
Ten-Year Government Bond Rate (percent)	7.7	7.2	7.2	6.6	6.2	5.9	5.6
Corporate Profits (percent of GNP)	7.1	7.2	7.1	7.1	7.2	7.2	7.4
Wage and Salary Disbursements (percent of GNP)	49.2	49.2	49.2	49.4	49.5	49.6	49.7
Other Taxable Income (percent of GNP)	20.3	20.3	20.1	19.8	19.5	19.2	18.9

SOURCE: Congressional Budget Office.

TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1989-1992

Economic Variable	Actual	Forecast		Projected			
	1986	1987	1988	1989	1990	1991	1992
Nominal GNP (billions of dollars)	4,163	4,399	4,698	5,033	5,406	5,792	6,186
Nominal GNP (percent change)	5.7	5.7	6.8	7.1	7.4	7.1	6.8
Real GNP (percent change)	2.7	2.6	3.0	3.0	3.1	2.8	2.5
Implicit GNP Deflator (percent change)	2.9	3.0	3.6	4.1	4.2	4.2	4.2
CPI-W (percent change)	2.1	2.7	4.3	4.4	4.3	4.3	4.3
Unemployment Rate (percent)	7.0	6.7	6.5	6.4	6.1	6.0	6.0
Three-Month Treasury Bill Rate (percent)	6.4	5.5	5.7	5.6	5.5	5.4	5.2
Ten-Year Government Bond Rate (percent)	8.3	7.2	7.2	6.8	6.3	6.0	5.7
Corporate Profits (percent of GNP)	7.1	7.2	7.1	7.1	7.2	7.2	7.3
Wage and Salary Disbursements (percent of GNP)	49.2	49.2	49.2	49.3	49.5	49.6	49.7
Other Taxable Income (percent of GNP)	20.3	20.1	20.2	19.9	19.6	19.3	19.0

SOURCE: Congressional Budget Office.

growth and by the increase in employer contributions for social insurance slated for 1988, but the reduction in interest expense and reduced foreign competition as the dollar falls will work to increase profits. On balance, the profit share in 1992 is expected to be somewhat higher than in 1986.

Alternative Economic Projections. To indicate the sensitivity of budget outcomes to economic conditions, CBO has prepared two alternative sets of economic projections, one with higher real growth and the other with lower real growth than the baseline (see Table I-4 and Figure I-1). These paths suggest a plausible range of uncertainty for the entire period, but they do not encompass all possible outcomes, particularly for short periods.

The high-growth path assumes that the growth rate of real GNP through 1992 averages 4.2 percent, about 1.4 percentage points higher than that of the baseline. Because of such strong growth, the civilian unemployment rate falls to 6.0 percent by 1988 and 4.6 percent by 1992. These rates of unemployment are below levels usually associated with stable inflation, and as a result the inflation rate rises dramatically on the high path, reaching 8.9 percent by 1992. Interest rates also rise more sharply than on the baseline, reflecting both higher inflation and presumed efforts by the Federal Reserve Board to restrain it.

The low-growth path assumes that a recession occurs in the second half of 1987. In depth and duration, it mimics that of 1973-1975. The assumed recovery is average by postwar standards. The unemployment rate rises to 9.9 percent in 1988 and in 1992 falls only to 8.4 percent. With high unemployment rates, the inflation rate, which before the recession is assumed to be slightly above its baseline level, falls to 2.4 percent in the 1990-1992 period. Nominal interest rates, which are also assumed to rise above baseline levels before the recession, fall well below the baseline after the recession. Nevertheless, the real interest rate on three-month Treasury bills is nearly half a percentage point above its baseline level in 1992.

FISCAL AND MONETARY POLICY

Judged by the monetary aggregates, reserve measures, and money market indicators, monetary policy was accommodative in 1986. Fiscal policy was stimulative, as the deficit reached record levels. It will probably be restrictive in the future, however, particularly if the targets of the Balanced Budget Act are met.

TABLE I-4. ALTERNATIVE ECONOMIC PROJECTIONS
(By calendar year)

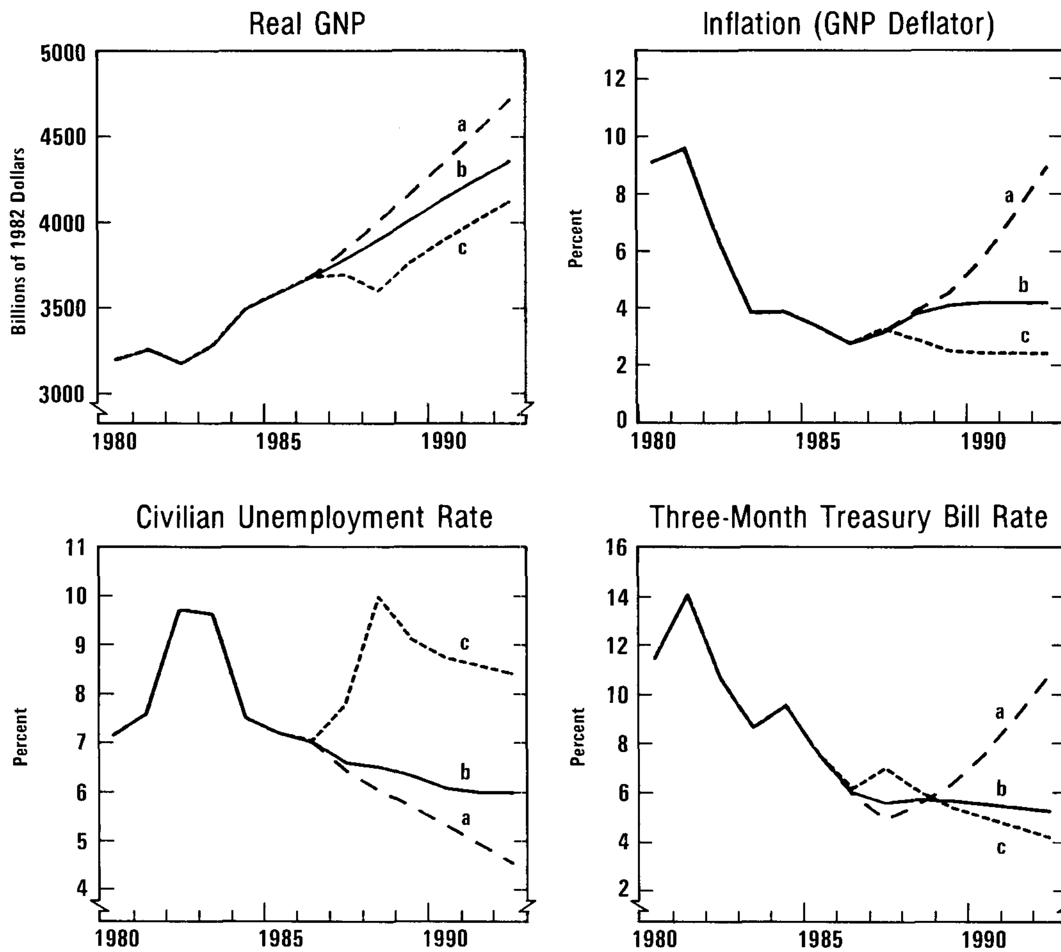
	1987	1988	1989	1990	1991	1992
Nominal GNP (billions of dollars)						
High	4,533	4,910	5,347	5,888	6,578	7,466
Baseline	4,469	4,779	5,124	5,503	5,888	6,288
Low	4,369	4,380	4,703	4,979	5,246	5,528
Real GNP (percent change)						
High	4.2	4.2	4.2	4.2	4.2	4.2
Baseline	2.8	3.0	3.0	3.1	2.7	2.5
Low	0.4	-2.6	4.7	3.4	2.9	2.9
Implicit GNP Deflator (percent change)						
High	3.2	3.9	4.5	5.7	7.2	8.9
Baseline	3.2	3.8	4.1	4.2	4.2	4.2
Low	3.3	2.9	2.5	2.4	2.4	2.4
CPI-W (percent change)						
High	3.5	4.4	4.7	5.7	7.1	8.6
Baseline	3.5	4.3	4.3	4.3	4.3	4.3
Low	3.6	3.5	2.9	2.7	2.7	2.7
Unemployment Rate (percent)						
High	6.4	6.0	5.7	5.3	5.0	4.6
Baseline	6.6	6.5	6.3	6.1	6.0	6.0
Low	7.8	9.9	9.1	8.7	8.6	8.4
Three-Month Treasury Bill Rate (percent)						
High	4.9	5.5	6.3	7.5	9.0	10.8
Baseline	5.6	5.7	5.6	5.5	5.3	5.2
Low	7.0	6.0	5.4	4.9	4.5	4.2

SOURCE: Congressional Budget Office.

Fiscal Policy

Fiscal policy remains headed toward a very restrictive course, assuming that the deficit targets of the Balanced Budget Act of 1985 are achieved in 1988 and subsequent years. CBO now estimates that the baseline federal

Figure I-1.
Alternative Economic Assumptions



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

[a] High path.

[b] Baseline.

[c] Low path.

deficit will decline from $221 billion in fiscal year 1986 to $174 billion in 1987. To satisfy the requirements of the Balanced Budget Act, the fiscal year 1988 deficit cannot exceed $108 billion--a further decline of about $66 billion. Substantial policy changes, however, will be needed to achieve that target, since CBO projects that without them the 1988 deficit would be $169 billion.

Although the Balanced Budget Act limits the size of future federal deficits, these limits do not accurately describe the nature of discretionary fiscal policy, because actual deficits are also affected by economic conditions. A better gauge of discretionary fiscal policy is provided by the standardized-employment deficit--the deficit calculated at some benchmark rate of unemployment, here taken to be 6 percent. According to this budgetary measure, fiscal policy will be very restrictive during the forecast period if the targets of the Balanced Budget Act are achieved in 1988 (see Table I-5 and Figure I-2); that is, the standardized-employment deficit is projected to fall from 4.4 percent of potential GNP

TABLE I-5. FISCAL POLICY AS MEASURED BY THE STANDARDIZED-EMPLOYMENT DEFICIT (By fiscal years)

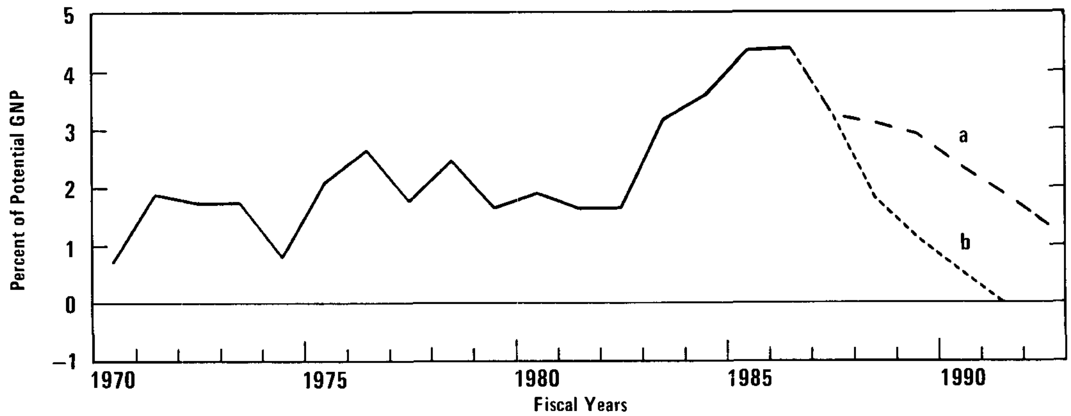
Standardized-Employment Deficit	Actual 1986	1987	1988	1989	1990	1991	1992
			Billions of Dollars				
Baseline	187	144	146	146	128	110	86
Balanced-Budget Target a/	138	113	85	56	30	0	n.a.
			Percent of Potential GNP				
Baseline	4.4	3.2	3.1	2.9	2.4	1.9	1.4
Balanced-Budget Target a/	3.2	2.5	1.8	1.1	0.6	0.0	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. The targets of the Balanced Budget and Emergency Deficit Control Act of 1985, adjusted to a standardized-employment deficit basis..

Figure I-2.
Standardized-Employment Deficit



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

[a]CBO baseline.

[b]Balanced Budget Act targets following 1987.

in 1986 to 3.2 percent in 1987 and 1.8 percent in 1988. 4/ The degree of fiscal restraint, however, could be much less if a substantial proportion of the required deficit reduction in 1988 is the result of asset sales. Compared with spending cuts, asset sales are thought to have little direct short-run impact on aggregate demand. Moreover, even though sales of assets reduce reported federal deficits in the year of the sale, they do not reduce federal credit demands and absorption of savings from the private sector.

Economists have widely diverging views regarding the short-run impact of fiscal restraint on output and employment. Some analysts maintain that reductions in federal spending have a substantial impact on aggregate demand, implying that the large amount of restraint projected under the Balanced Budget Act could produce slower growth. Others argue that fiscal policy is not likely to dampen growth significantly in the current situation, largely because of the stimulative effects of lower interest rates. One such view stresses that the expectation of sustained fiscal restraint

4. A significant amount ($12 billion) of the fiscal restraint in 1987 results from the temporary revenue-raising effect of the Tax Reform Act of 1986. Excluding these revenues from the 1987 standardized-employment budget calculations, there will be less fiscal restraint in 1987 and more in 1988. Asset sales and other factors, discussed in Chapter II, have a similar effect on the allocation of fiscal restraint between 1987 and 1988.

tends to lower current long-term interest rates, and thus boost interest-sensitive private spending. Another consideration is that with flexible exchange rates, the lower interest rates brought about by current and expected fiscal restraint reduce capital inflows from abroad, which in turn stimulates net exports through a depreciation of the dollar. Nevertheless, there is some risk that the large amount of fiscal restraint assumed for this year and next could slow growth in output below that projected by CBO, even if monetary policy, the recent decline in interest rates, and falling exchange rates provide a strong stimulus to the economy. 5/

Continued adherence to the targets of the Balanced Budget Act would dramatically reduce the standardized-employment deficit, eliminating it by 1991--a situation not observed in 25 years. Most economists agree that such a development would increase net national saving, reduce real interest rates, and thus promote capital formation and long-term growth of productivity and living standards. Some economists argue that a portion of the favorable long-term impact on capital formation of eliminating the structural deficit may be offset by various provisions of the Tax Reform Act of 1986. In particular, the new tax law eliminates the investment tax credit for business equipment and significantly reduces depreciation allowances for structures. Though the corporate tax rate is reduced substantially, the net result of tax reform is to raise the average effective tax on business income. The Tax Reform Act of 1986, however, taxes various types of business capital more equally. This change will encourage capital to flow to those sectors of the economy in which it is more productive, rather than to those sectors which, under the old law, provided the greatest tax advantage. The end result may be a smaller capital stock than would emerge under the old law, but one that is used more efficiently.

Many analysts believe the new law is beneficial to saving, and is less conducive to borrowing, because it lowers marginal tax rates. 6/ If saving is

---

5. Throughout the 1980s, the major countries of the Organization for Economic Cooperation and Development (OECD), excluding the United States, have followed a course of fiscal discipline, reflected by continuing declines in the average standardized-employment deficit relative to GNP. This action accentuated the effect of fiscal stimulus on the trade balance in the United States. A continuation of fiscal restraint by the OECD countries next year will tend to offset the favorable effects on the trade balance of a U.S. shift to fiscal restraint.

6. The restrictions on consumer interest deductions should also make borrowing more costly. On the other hand, higher capital gains taxes and restrictions on partnership losses work in the opposite direction by reducing after-tax returns on some forms of private saving. The new law is also less favorable to certain types of retirement saving, but most analysts believe this will have a relatively minor impact on total saving.

indeed increased, interest rates will be lower than they would be in the absence of tax reform. As a result, some of the adverse effects of the higher effective corporate tax rates mentioned above are likely to be offset. Lower tax rates on individuals may also be beneficial to economic growth because of their effect on work effort. 7/

Financial Markets and Monetary Policy

The rally in financial markets, which began in mid-1984, continued unabated through the first half of 1986 before slowing at midyear. The expansion in the prices of financial assets--both stocks and bonds--had been fueled by reduced credit demands, lower inflation, accommodative monetary policy, and expectations of lower federal deficits in the future. Fears of a pickup in inflation and concerns as to the sustainability of the economic expansion into 1987 appear to have caused a slowing of the boom in the stock and bond markets, though the stock market continued to hit new highs.

Interest Rates. In early 1986, interest rates continued the rapid decline that had begun six quarters earlier (see Figure I-3). Although the drop occurred across the whole spectrum of maturities, it was sharpest among the long-term instruments. As a result, the yield curve flattened significantly and remained flat through midyear. In early fall, rapid growth in money supply and increasing import prices raised fears of inflation, causing long-term rates to increase. Short-term rates fell, however, and the yield curve steepened. The most recent data once again indicate a flattening of the yield curve, though it is still steeper than in June 1986.

Real short-term interest rates continued their downward trend in 1986. As measured by the nominal three-month Treasury bill minus the next three month's rate of change in the personal consumption deflator, the real short-term interest rate fell below the 2 percent level in the last quarter of the year (see Figure I-4). Many forecasters, including CBO, are expecting a slight pickup in economic activity this year and a modest increase in nominal short-term interest rates over the course of the year.

The behavior of the stock market mirrored that of the bond market, expanding rapidly in the first half of last year and then slowing in the latter

7. The theoretical effect of lower marginal tax rates on work effort is ambiguous. The increased reward for an extra hour of labor should increase work effort, but the resulting higher level of after-tax income could enable people to achieve their own goals for private consumption with less work. Empirical studies generally find only a slight effect of after-tax wages on total hours worked, but find a considerably larger effect on the work effort of some second earners.